October 31, 1991

COORDINATED ISSUE
SAVINGS AND LOAN INDUSTRY
CORE DEPOSIT INTANGIBLES

Issue:

Should the excess purchase price paid for a savings and loan association over the tangible assets acquired, be treated as goodwill/going concern value or as an amortizable intangible asset called core deposit intangibles.

Recommended Position:

As a general rule, the core deposit intangible is indistinguishable from goodwill/going concern value.

Discussion:

There have been many mergers and acquisitions in the thrift industry in recent years. Some financial institutions have been acquired for as much as 2 1/2 times book value. Rather than identify the entire purchase premium as goodwill, savings and loan institutions have allocated this premium to amortizable intangibles.

One of the most prominent of these intangible assets is the "core deposit intangible". The Comptroller of the Currency has defined "core deposit intangible" as the deposit base of demand and savings accounts which, while not usually legally restricted, are generally based on stable customer relationships that the financial institution can expect to maintain for an extensive period of time, often many years. [Jumbo Certificates of deposit, $100,000 denominations or more, are normally excluded from this definition as they are considered more indicative of a borrower-type, rather than a customer relationship.]

Historically, intangible assets have been amortized for book purposes by both banks and thrifts. National banks were allowed to capitalize and amortize the value of customer deposit relationships "under appropriate circumstances" by the Comptroller of the Currency on December 21, 1981 (Circular # 164). The FDIC adopted a similar policy on March 5, 1982.

The Internal Revenue Code also allows amortization of intangible assets. Treas. Reg. 1.167(a)-3 provides that depreciation of an intangible asset is allowable if that asset has a limited useful life which can be estimated with reasonable accuracy, an

ascertainable value, and is separate and distinct from goodwill. No depreciation deduction is allowed for goodwill.

Accountants characterize goodwill as the potential of a business to earn above normal profits. Conceptually, goodwill is the present value of the expected future excess earnings. Goodwill arises as a result of such factors as customer acceptance, efficiency of operation, location, internal competency and financial standing.

The United States District Court for the Northern District of Alabama has ruled in favor of the Service on the core deposit issue. In AmSouth Bancorporation and Subsidiaries, 88-1 USTC 9232 (2-25-88), the Court specifically ruled that the bank was not entitled to depreciate the customer deposit base it acquired through the purchase of the assets and liabilities of another financial institution. The Court ruled that the customer deposit base is inseparable from goodwill.

The courts have also spoken at length to the question of what constitutes goodwill. In Boe v. Commissioner 307 F.2d 339 (9th Cir. 1962), the court stated that ... the essence of goodwill is the expectancy of continued patronage, for whatever reason ... at 343. The Tax Court has defined goodwill as the probability that old customers will resort to the 'old place' without contractual compulsion. Brooks v. Commissioner 36 TC 1128, at 1133. (1961). This definition has also been used in the Fifth and Seventh Circuits. See: Commissioner v. Killian, 314 F.2d 852, 855 (5th Cir. 1963) and Karan v. Commissioner 319 F.2d 303, 306 (7th Cir. 1963).

In Revenue Ruling 74-456, the government held that, generally, customer and subscription lists (when considered as mass, indivisible assets) location contracts, insurance expirations, etc, represent the customer structure of a business, whose value lasts until an indeterminate time in the future. Such assets are in the nature of goodwill or otherwise have indeterminate lives. The ruling assumes that a mass asset is really one asset, the loss of any part of which is offset in a continuing manner by additions thereto; the "regenerative theory". It should be noted that bankers themselves liken core deposits to customers lists.

The Tax Court in First National Bank of Omaha v. Commissioner, TC Memo 1975-67 (1975) citing to The First Pennsylvania Banking and Trust Company 56 TC 677 (1971), noted "If, however, the purchaser has not paid for mortgage servicing rights, but rather has purchased goodwill, going concern value, business organizations, investor and borrower relationships, (emphasis added), opportunities for future business and income and similar intangibles, he is not entitled to a deduction for amortization". at 364.

In contrast, the Court in Midlantic National Bank v. Commissioner, TC Memo 1983-581 (1983), factually determined that no goodwill or going concern value was acquired in a

transaction involving the acquisition of the right to solicit the customers of an insolvent bank, which was obtained separately from the FDIC. The petitioner successfully bid for the right to solicit the depositors of a failed financial instutution as those depositors were being paid off by the FDIC. When an account attributable to that particular solicitation was subsequently closed, the petitioner deducted an amount allocated to the acquisition of that account.

The Tax Court determined that the solicitation right that petitioners acquired was the approximate equivalent of an acquired customer list, and allowed the deductions. However, the treatment of costs to acquire the right to solicit former depositors of another, failed institution, in order to develop a new deposit base in another separate institution is distinguishable from the treatment of costs incurred to acquire a pre-existing deposit base in a going concern thrift which is made part of the taxpayer's network of financial institutions. This would also be the case when the failed institution is not closed, but rather the signs of ownership merely changed from one day to the next. In these cases, the amounts paid to acquire the deposit base would not be amortizable or depreciable because there is no wasting asset but rather an ongoing stream of customers and deposits.

In Southern Bancorporation, Inc. v. United States 732 F.2d 374 (4th Cir. 1984), the circuit court rejected the taxpayer's post hoc upward revaluation of the loan portfolio it acquired, and found the premium paid to acquire a failing bank was attributable to its going concern value. Although the bid to acquire the failed institution was calculated as a percentage of the largest deposits, the taxpayer did not pursue its argument that it had acquired "cheap money" which it believed was an amortizable asset. The Court noted that the taxpayer had failed to show that it intended to pay an enhanced value for the loan portfolio at the time of acquisition. The Court was persuaded by the evidence offered by the government which indicated that the loans in aggregate were worth less, not more, than face and that the premium was paid to obtain the going concern value of the largest branches.

This decision was subsequently appealed and the decision of the Tax Court was affirmed by the 4th Circuit on 5-16-88. Refer to 88-1 USTC 9344.

The Tax Court in Banc One Corp. v. Commissioner, 84 TC 476 (1985) also held that the petitioner was not entitled to deduct depreciation for core deposits. The Court rejected the taxpayer's method of estimating the useful life of the core deposits primarily because the information relied upon in the computation was based on hindsight. The taxpayer submitted deposit base studies which relied upon events occuring after the acquisition date. The Court ruled that evidence of experience subsequent to the year in issue could be used as corroboration for establishing a useful life, but it could not be used to support the computation. Since the Court rejected the computation, and thus decided the issue, it expressed no opinion as to

whether core deposit intangibles are properly amortizable.

Conclusion:

Based on the arguments and authorities cited above, our position is that the so-called "core deposit intangible" is not sufficiently distinguishable from goodwill/going concern value to allow a deduction for amortization.